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The Piper Comes Calling

An Overview of Some Legal and Practical Implications of GASB Statements 43 and 45, the New Accounting Rules for Other Post-Employment Benefits ("OPEB's")

by

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INTRODUCTION

Several factors (chiefly, an aging workforce and a medical care cost inflation rate that continues to outpace general price level inflation) have caused a substantial increase in the likely future cost to governmental employers of providing promised retiree welfare benefits. Now, new accounting standards are requiring governmental employers to come to terms with those increased costs through some combination of increased revenues, changed allocation of existing revenues, effective use of available financial and tax strategies, or benefit reductions. This is occurring in an environment in which private sector employees (a/k/a, "voters") are suffering (or, in many cases, have suffered) substantial reductions in, or eliminations of, their own retiree welfare benefits, while federal and state "universal coverage" proposals offer hope for future cost relief, but add uncertainty regarding future outlays.

THE ACCOUNTING STANDARDS AND THEIR EFFECTIVE DATES

New Governmental Accounting Standards Board ("GASB ") Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*, prescribes the required financial reporting by governmental employers for postemployment benefits other than pensions (i.e., retiree medical, prescription drug, dental, and vision benefits; life insurance and long-term care insurance, if not provided through a pension plan).[1] These benefits are referred to in GASB 45 as "other postemployment benefits," or "OPEB's." A companion GASB Statement, GASB No. 43, prescribes the financial reporting for OPEB funds as entities separate from their sponsoring employers.

The required implementation date for GASB 45 depends on a governmental employer's total annual revenues in its first fiscal year ending after June 15, 1999. The required implementation date for GASB 43 depends on the total annual revenues of the plan's sponsoring employer (or, in the case of a multiple employer plan, the total annual largest participating employer) in the employer's first fiscal year ending after June 15, 1999, and in all cases is one year earlier than the corresponding GASB 45 implementation date. The following table summarizes the required GASB 43 and 45 implementation dates:

[1] Because retiree medical is typically by far the most expensive component of an employer's OPEB, this paper will refer to retiree medical and OPEB interchangeably in places.

Employer revenue in first fiscal year ending after June 15, 1999	Reporting required for fiscal years beginning after	
	Funds (GASB 43)	Employers (GASB 45)
$100 million or more	December 15, 2005	December 15, 2006
Between $10 million and $100 million	December 15, 2006	December 15, 2007
Less than $10 million	December 15, 2007	December 15, 2008

Thus, for example, a large employer (i.e., one with total annual revenue for its first fiscal year ending after June 15, 1999 of $100 million or more) with a July 1-June 30 fiscal year will first be required to report its OPEB obligations in accordance with GASB 45 in its financial statements for its fiscal year ending June 30, 2008. If the employer sponsors or participates in an OPEB fund and the fund also has a July 1-June 30 fiscal year, the fund would first need to prepare its financial statements in accordance with GASB 43 for its fiscal year ending June 30, 2007.

WHAT GASB 45 REQUIRES AND HOW THIS DIFFERS FROM WHAT GOVERNMENTS AND AGENCIES PREVIOUSLY REPORTED AS THEIR OPEB LIABILITY

Governmental employers have traditionally funded OPEB's on a pay as you go ("PAYGO") basis. That is, the payment of each year's premium or benefit expense was simply made from current revenues without prefunding and the annual PAYGO expenditure was reported in financial statements. Under PAYGO accounting, OPEB liabilities are not accrued as they are earned by active employees, and there is no requirement to determine the employer's total accrued liability to retirees and to active employees for already earned benefits. This is similar to the reporting of OPEB expense by businesses before the imposition of Financial Accounting Standards Board ("FASB") Statement No. 106 in 1992.

GASB 45, like FASB 106, requires that governmental employers determine and disclose in their financial statements: (a) their unfunded actuarial accrued liability ("UAAL"),[2] and (b) the actuarial value of new benefit rights earned each year by active employees after the implementation date. The employer need not, however, accrue the entire UAAL as a liability on its balance sheet on the implementation date.[3] Instead, employers are required to record in their financial statements annually an amount called the "annual required contribution" ("ARC"). The ARC consists of (a) the present value of the future benefits actually earned during the year by active employees (called in actuarial parlance, the year's "normal cost"), plus an amount necessary to amortize the UAAL over a period of no more than 30 years.

If the employer funds all of the ARC for the year, then there is no increase in the employer's balance sheet liability for OPEB. On the other hand, any portion of the ARC

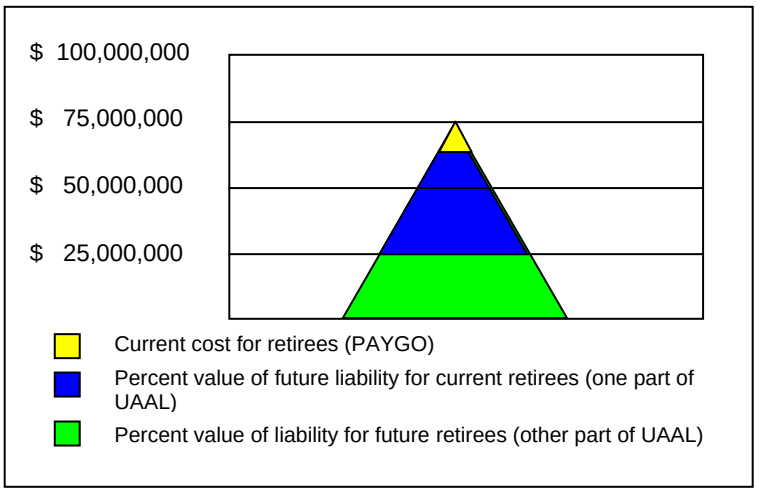
[2] The UAAL is the present actuarial value as of the GASB 45 implementation date of all plan obligations to retirees and active employees for previously earned benefits, reduced, if the plan is funded, by the present actuarial value of the plan's assets.

[3] That is, unlike FASB 106, there is no requirement to book immediately a huge "transition liability."

that is not funded must be recorded as a balance sheet liability and will increase annually thereafter with interest.

The employer's annual normal cost for OPEB's, as the present value of future benefit rights currently earned by active employees, is likely in and of itself to exceed the employer's PAYGO amount. When the cost of amortizing the UAAL over 30 years is added to the normal cost, an employer's ARC is likely to be a multiple of the PAYGO amount that it has traditionally expensed, resulting in OPEB "sticker shock."

Actuaries have used an "iceberg" analogy to summarize the relationship between an employer's PAYGO amount, normal cost, and UAAL. The PAYGO amount is the "tip" of the OPEB iceberg, with the present value of future normal costs for the current workforce, and the UAAL, together being the vastly larger portion of the OPEB iceberg submerged beneath the surface of municipal financial statements. Milliman, USA provided the following example, based on a study it had performed for one of its clients, in its December 2002 PERiScope newsletter:



THE "SUBSTANTIVE PLAN"

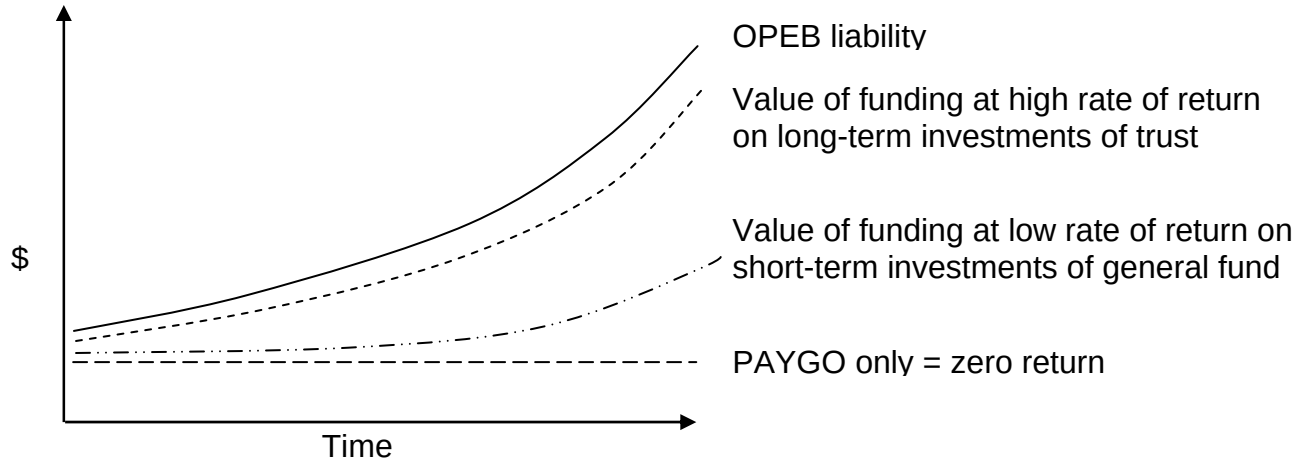
GASB 45 requires that valuation of both the employer's normal cost and its UAAL be based on what GASB 45 refers to as the "substantive plan," which is the plan as its terms are understood by the employer and the plan's members at the time of the actuarial valuation. The "substantive plan" is evidenced by written documents (e.g., municipal ordinances, board resolutions), employee and retiree communications (e.g., a plan summary prepared by the employer or insurer), and by patterns and practices (e.g., an established pattern of cost sharing between the employer and retirees, even if not prescribed by statute). Under GASB 45, legal or contractual limits ("caps") on an employer's share of costs are taken into account in determining the "substantive plan" only if the limits may be assumed to be effective based on a past pattern of enforcement. In other words, the "substantive plan" is more of a business concept than a strictly legal one. It is the pattern of future expenditures for OPEB that the employer is considered to be committed to, not the unavoidable cost of its strict legal obligations.

ACTUARIAL AND FUNDING ISSUES

The two key actuarial factors in determining an employer's liability under GASB 45 are: (a) the future trend of medical care cost increases, which is outside the employer's control, and (b) the assumed rate of return on assets set aside and invested by the employer to fund its future OPEB liability, which to a great extent is within the employer's control.

To the extent that an employer continues to fund annually only its PAYGO amount, thus leaving the remaining portion of the ARC unfunded, as it likely did in the past, plan assets are zero and the rate of return on plan assets is zero. If the employer funds annually more than its PAYGO amount, but does not set the excess funds aside in a trust or equivalent arrangement protected from the employer's creditors that commits the funds irrevocably to satisfaction of the employer's OPEB liabilities, then the rate of return on the plan's assets assumed for GASB 45 purposes will be the typically low rate of return earned by the employer on the short-term investments made for the employer's general fund, e.g., 1%. However, if amounts in excess of the PAYGO amount are set aside irrevocably in a trust or equivalent arrangement established to fund OPEB and protected from the employer's creditors, then the assumed rate of return on plan assets will be the much higher rate of return that can reasonably be expected to be earned on a well-diversified portfolio of long-term investments.

Because each year's accrual of future OPEB liability is projected into the future using the expected rate of medical care cost inflation, while the value of the plan's assets is projected into the future using the expected rate of return on the plan's investments, the use of a trust or equivalent vehicle to fund OPEB liabilities can make a very significant difference in the amount of an employer's reported OPEB liabilities. The following diagram illustrates the relationship between the growth in future value of a booked OPEB liability versus the expected rate of return on plan assets:



TAX-EFFICIENT VEHICLES FOR ACCUMULATING PLAN ASSETS TO FUND OPEB LIABILITIES

There are three main approaches to funding OPEB: IRC § 401(h) medical benefit accounts in defined benefit pension plans; IRC § 501(c)(9) voluntary employees' beneficiary associations ("VEBA's"); and IRC § 115 trusts. All of these approaches will generally have the desired results of:

- Enabling the employer to use a favorable assumed high rate of return on investments to reduce its UAAL
- Providing retirees and active employees with confidence that the employer will fulfill its OPEB commitments
- Avoiding federal income tax on fund investment income and benefit payments

Under IRC § 401(h) and related Treasury regulations, a defined benefit plan may include a feature for the payment of nontaxable medical benefits to retirees. The medical benefits must be paid from a separate account maintained within the plan, and the funds to pay medical benefits from the plan must be separately accumulated. Annual funding of the 105(h) benefit may not exceed 25% of annual contributions for retirement benefits (i.e., 20% of total plan contributions, including the 401(h) amount).

The annual contribution limit on the funding of a 401(h) account is a substantial limitation on its use in certain situations, e.g., if the pension plan is fully funded or, because of a shrinking base of active employees, the retiree population is large relative to the active population. Nevertheless, in some situations, a 401(h) account could be an important part of an employer's GASB 45 strategy.

A VEBA under IRC § 501(c)(9) is a separate, tax-exempt entity, typically a trust. VEBA's have traditionally been employed by both private employers and tax-exempt and governmental employers to pre-fund welfare benefits for active and retired employees. However, because VEBA's do not provide any benefits that are not also offered by "Section 115 trusts," and have somewhat greater IRS filing and reporting requirements, most employers that do not already sponsor VEBA's are likely to opt for "Section 115 trusts" for prefunding OPEB's.

Section 115(1) of the Code exempts from income tax any income derived from an essential governmental function and accruing to a state, political subdivision of a state, or state instrumentality. A "Section 115 trust" is an irrevocable trust established by a governmental employer or group of employers to fund OPEB. The IRS has recently issued several private letter rulings holding that where a governmental employer or group of governmental employers establishes an irrevocable trust for the prefunding and payment of retiree medical expenses: (a) The trust will enjoy the IRC § 115(1) exemption from tax on its income; (b) contributions to the trust will not be taxable to retirees or their eligible dependents; and (c) medical benefits or insurance

received by retirees or their eligible dependents from the trust will not be taxable to them. See Ltr. Ruls. 200606007, 200619014, 200626027, and 200703015. Some Section 115 trusts are being formed jointly by groups of governmental employers. Generally, this is being done not to pool risk,[4] but rather to achieve economies of scale with respect to legal, custodial, actuarial, and accounting fees.

Because IRS private letter rulings are directed only to the requesting taxpayer and cannot be used or cited as precedent, and because Section 115 trusts used to fund OPEB are a relatively recent phenomenon that are based on the application of broad tax principles and not any detailed published guidance, it is suggested that any governmental employer or group of governmental employers contemplating the formation of a "Section 115 trust" obtain its or their own private letter ruling from IRS approving the arrangement. Additionally, each employer must determine whether it has the authority to establish such a trust, and if not, to obtain it (e.g., by enactment).

OTHER WAYS TO REDUCE OPEB COST

Most employers will want to consider modifying their OPEB promises in order to reduce OPEB cost. Such modifications may take many forms:

- Eligibility of retirees and their dependents can be restricted, e.g., by increasing the number of years that an employee must work for the employer to be entitled to OPEB, increasing the retirement age, or both.

- Retiree co-pays and coinsurance percentages may be increased in the underlying plan.

- Retiree premium cost sharing may be introduced or increased.

- Employer contributions for retiree medical benefits may be capped, essentially transferring liability for medical care cost inflation to retirees.

- The employer may shift from a defined benefit to a defined contribution approach for providing retiree medical benefits, which will have the effect of capping the employer's cost and shifting future medical care cost inflation to retirees, while also providing retirees with greater control over their medical expenditures and care strategies.

Any modification to existing retiree benefits that has the effect of reducing the employer's cost will obviously not only be perceived as, but actually be, a "take-away," and thus runs human resources, political, and legal risks. If the benefits are provided under a collective bargaining agreement, then generally the legal issues presented are subject to applicable labor laws and collective bargaining agreement provisions. Outside the collective bargaining arena, retirees may mount legal challenges based on contract law, statutory interpretation, promissory estoppel, or state constitutional

[4] Separate accounts or sub-trusts are generally maintained for each contributing employer, so the risk in fact is not pooled

protections. Our experience has been that in most cases, governmental employers will find that the basis for legal challenges to modifications to retiree welfare benefits are weak, and thus that the human resources and political hurdles to benefit reductions are higher than the legal hurdles.

NCPERS recently commissioned a state-by-state study of cases dealing with challenges to reductions in retiree benefits by governmental employers. A summary of the study's findings can be found at www.ncpers.org/artman/uploads/health_benefit-protections.pdf. Although brief, and many states do not appear to have any cases on point, the NCPERS study is a good place for any governmental employer contemplating changes to its retiree medical benefits to start its investigation of legal risks.

EFFECT OF GASB 45 ON BOND RATINGS

Fitch, Standard & Poors, and Moody's have all indicated, generally, that the sudden appearance of increased OPEB liabilities in the financial statements of governments and governmental agencies will be recognized for what it is, i.e., an increased awareness and more elaborate and disciplined measurement of an existing exposure rather than a new liability. The rating agencies have indicated that they will be more concerned with the way that governmental employers address their OPEB obligations on a going-forward basis than with the initial amounts of those obligations. However, the rating agencies are looking for an active approach by employers to managing OPEB liability, e.g., by prefunding, gradual benefit reductions, or both, and have indicated that an employer's indefinite deferral of the difficult task of dealing with OPEB's will likely be damaging to its credit rating.

RECENT DEVELOPMENTS

GASB 45 has made taxpayers and politicians more mindful of OPEB liabilities. See, e.g., in New Jersey, "State health benefits task swells to $78B," by Dunstan McNichol, The Star-Ledger, February 07, 2007; "Hearing grapples with retirement," by Peter Hecht, The Sacramento Bee, March 10, 2007.

In Texas, a bill has been introduced into the state legislature that would exempt Texas governments and agencies from GASB 45 compliance. "Texans Want to Strike Rule on Projecting Retiree Costs," by Mary Williams Walsh, The New York Times, March 12, 2007. However, the bill appears to be encountering stiff opposition, as well it might. "Bills resist U.S. accounting mandate," by Yamil Berard, Houston Star-Telegram, March 23, 2007.

In California, multiple employer Section 115 trusts are being promoted to governmental employers wishing to prefund at least some of their OPEB liability without "reinventing the wheel." See, CalPERS Formally Launches Prefunding Plan for Retiree Health Benefits, CalPERS Press Release March 1, 2007; California State School Boards Association GASB 45 Solutions program (www.csba.org/ds/gasb45.htm).

National publications and polls indicate a shift in public opinion toward a comprehensive federal solution to the problems of medical insurance cost and the

availability of coverage for many non-Medicare eligible individuals. "Winds of change carrying cries for health care toward the Hill," by Lance Diukie, Seattle Times, march 23 2007; "Universal Health Care Momentum Swells," by Ruy Teixeira, The Century Foundation, March 23, 2007 (www.tcf.org).